No. 10,644

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

LORIN A. CRANSON,
Appellant,
vs.
THE UNITED STATES OF AMERICA,
Appellee.

APPELLANT'S OPENING BRIEF.

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STATEMENT OF JURISDICTION.

Appellant filed suit against the United States in the United States District Court for the Northern District of California, Southern Division, for the refund of income tax paid for the calendar year 1936 in the amount of $51.84. (R. 2-6.) The District Court had jurisdiction by virtue of the provisions of Section 24(20) of the Judicial Code (Title 28 U.S.C. Sec. 41(20), 36 Stat. 1093, 44 Stat. 121) which confers jurisdiction upon the District Courts concurrent with the Court of Claims, of all claims not exceeding $10,000, for the recovery of any Internal Revenue taxes alleged to have been erroneously or illegally assessed or collected or any sum alleged to have been excessive, or even if the claim exceeds $10,000 if the Collector of Internal Revenue by whom such tax was collected is not in office as Collector of Internal Revenue at the time such suit is commenced.

The District Court rendered judgment in favor of the United States. (R. 60-61.) This Court has jurisdiction of this appeal to review the judgment of the District Court by virtue of the provisions of Section 128(a) of the Judicial Code. (Title 28 U.S.C. Sec. 225, 52 Stat. 779.)

STATEMENT OF THE CASE.

During the calendar year 1936 appellant received from Honolulu Oil Corporation dividends in the sum of $450. Appellant reported the full amount thereof on his income tax return for 1936 as taxable dividends received. (R. 28-29.) Appellant thereafter filed two claims for refund, each in the amount of $51.84, both claims being based on the ground that only $18 out of the $450 of said dividends received by appellant were taxable dividends, and that the balance of $432 was not paid out of the earnings or profits of said corporation and was not taxable to appellant. (R. 29-30.) Both of said claims for refund were disallowed by the Commissioner of Internal Revenue (R. 30-31), and appellant thereupon filed suit against the United States for the refund of said income taxes as hereinabove set forth.

The sole question involved in this appeal is the extent to which dividends declared by Honolulu Oil Corporation during the calendar year 1936 are subject to federal income tax. This is a test case brought on behalf of all stockholders of Honolulu Oil Corporation.

Two companion test cases have been filed for the purpose of determining the taxability of dividends declared by Honolulu Oil Corporation during the calendar years 1937 and 1938, respectively. These two cases are likewise on appeal to this Court and are entitled and numbered: J. F. Shuman v. The United States of America, No. 10,645, and Lorin A. Cranson v. The United States of America, No. 10,646. A stipulation has been filed in each of these two cases to abide by the decision of this Court in this case.

All three appeals involve the same question of law, which may be generally stated as follows: Where a corporation undertakes a new venture through the formation of a wholly owned subsidiary corporation, and the subsidiary is operated at a loss and is thereafter liquidated and dissolved, do the earnings of the parent corporation available for dividends remain undiminished by this unprofitable venture, with the result that distributions which are actually returns of capital are taxed to the stockholders as income? The District Court answered this question in the affirmative, and held that the unprofitable venture did not reduce the earnings of the parent corporation, which remained intact and unaffected by the loss sustained.

The facts giving rise to the foregoing question were stipulated, and found as stipulated by the Court below. The pertinent portion of the facts is as follows:

Honolulu Consolidated Oil Company was incorporated in 1910 under the laws of the State of California. In 1930 it was reincorporated under the laws of the State of Delaware as Honolulu Oil Corporation, Ltd. In 1937 the name of the corporation was changed to

Honolulu Oil Corporation. Both of said corporations will be referred to as "Honolulu". (R. 31.)

On August 31, 1936, Honolulu liquidated three wholly owned subsidiary corporations, hereinafter referred to as "Subsidiaries", and took over all their assets and assumed their liabilities. The liquidation of said wholly owned Subsidiaries was carried out under the nontaxable provisions of section 112(b)(6) of the Revenue Act of 1936. (R. 33.) One of said wholly owned Subsidiaries was California Exploration Company, Inc., which corporation resulted from the consolidation in 1934 of two prior wholly owned subsidiary corporations of Honolulu which had been formed by Honolulu to acquire and develop prospective oil properties in the States of Wyoming and Texas. (R. 31-32.) Another of said wholly owned Subsidiaries was Sea Cliff Development Company, Ltd., which had been formed by Honolulu to acquire and develop prospective oil properties in Ventura County, California. The third wholly owned subsidiary, Processco, Limited, was formed by Honolulu primarily to acquire and develop patents relating to the processing of crude petroleum. (R. 32.)

Each of said wholly owned Subsidiaries sustained operating losses during the period from their incorporation to their dissolution. In the case of California Exploration Company, Inc., both its predecessors also sustained operating losses up to the date of their consolidation in 1934, which operating deficits were carried forward on to the books of the consolidated company, California Exploration Company, Inc. The total operating deficits of said three wholly owned

Subsidiaries as of the date of their liquidation on August 31, 1936, was $1,205,451.61. (R. 36-37.)

Upon the liquidation of said wholly owned Subsidiaries and the transfer of all their assets to Honolulu, Honolulu realized a loss of $1,225,908.63.[1] (R. 33.)

In 1936, the year involved in this appeal, Honolulu paid cash distributions to its stockholders in the amount of $1.00 on each of its outstanding 937,743 shares of capital stock, or a total cash distribution of $937,743. (R. 38.) On January 1, 1936, Honolulu had available for dividends accumulated earnings or profits in the amount of $139,631.26. Honolulu's earnings or profits during the calendar year 1936 amounted to the sum of $931,553.82 before deducting any portion of said loss realized upon the liquidation of said Subsidiaries in the amount of $1,225,908.63, or before deducting the total operating deficits of said Subsidiaries in the amount of $1,205,451.61. (R. 38.)

It follows that if Honolulu's earnings or profits available for dividends are to be reduced by either said loss or said operating deficits it had no earnings during the calendar year 1936, and said distributions were in such case distributions of capital and not income to the recipients, except to the extent that effect

[1]The difference between this loss of $1,225,908.63 and the total operating deficits of the subsidiaries in the amount of $1,205,-451.61, referred to in the previous paragraph, is due to a payment of $20,457.02 made by Honolulu to third parties for a contingent interest in the capital stock of Processco, Limited. (R. 34.)

must be given to the accumulated earnings as of January 1, 1936.[2]

QUESTION FOR DECISION.

Specifically stated, the question for decision in this appeal is whether the operating deficits of said wholly owned subsidiaries as of the date of their liquidation in 1936, in the aggregate amount of $1,205,451.61, were absorbed by Honolulu upon the nontaxable liquidation of said subsidiaries, thus resulting in a reduction of the earnings of Honolulu otherwise available for dividends; or, in the alternative, whether the loss realized by Honolulu upon the liquidation of said wholly owned subsidiaries in 1936, in the amount of $1,225,908.63, reduced the earnings of Honolulu available for dividends.

SPECIFICATION OF ERRORS.

In support of his appeal, appellant relies upon the following specification of errors:

(1) The Court below erred in concluding that the operating deficits of the wholly owned subsidiary corporations of Honolulu Oil Corporation as of the date of their liquidation did not diminish the earnings or

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[2]It would appear that the accumulated earnings as of January 1, 1936, in the amount of $139,631.26 should be reduced by the loss for the year 1936 prorated on a daily basis to March 14, 1936, the date of the payment of the first dividend, and that the remainder of said accumulated earnings would then be available for the payment of that dividend. The remaining three dividends in 1936 are entirely paid out of capital.

profits of Honolulu Oil Corporation which were otherwise available for distribution to the stockholders of Honolulu Oil Corporation during the tax year.

(2) In the event that the Court below did not err as stated in paragraph (1) above, then the Court below erred in concluding

(a) that the loss sustained by Honolulu Oil Corporation upon the liquidation of its wholly owned subsidiary corporations did not diminish the earnings or profits of Honolulu Oil Corporation available for dividends during the tax year; and

(b) that the retroactive application of the Internal Revenue Code as amended by Section 501 of the Second Revenue Act of 1940 is not unconstitutional.

(3) The Court below erred in concluding that the Commissioner of Internal Revenue correctly determined that the claim for tax refund should be rejected.

(4) The Court below erred in failing and refusing to render judgment for plaintiff.

SUMMARY OF ARGUMENT.

I. The operating deficits of said subsidiaries were absorbed by Honolulu upon the nontaxable liquidation of said subsidiaries.

(a) The principle established by *Commissioner v. Sansome* (60 Fed. (2d) 931 (C.C.A. 2), certiorari denied, 287 U. S. 667), *United States v.*

Kauffmann, 62 Fed. (2d) 1045 (C.C.A. 9), and succeeding cases is that nontaxable reorganizations do not break the continuity of the corporate life as a continuing venture, with the result that under the doctrine of these cases it is held that the earnings or profits of the transferor corporation are transferred intact to the successor or transferee corporation.

(b) Under the doctrine of the *Sansome* case, that the continuity of the corporate life as a continuing venture is not broken, no valid distinction can be drawn between operating deficits on the one hand and earnings or profits on the other hand.

II. If it is held that the operating deficits of said subsidiaries were not absorbed by Honolulu, then it is contended in the alternative that the loss realized by Honolulu upon the liquidation of said subsidiaries reduced the earnings of Honolulu available for dividends.

(a) The term "earnings or profits" is not synonymous with statutory net income.

(b) In the determination of earnings or profits available for dividends it is not material that the loss realized by Honolulu upon the liquidation of its subsidiaries occurred in a tax-free transaction and was not recognized for income tax purposes.

(c) The attempted retroactive application of section 501 of the Second Revenue Act of 1940 violates the due process clause of the Constitution.

ARGUMENT.

I.

THE OPERATING DEFICITS OF SAID SUBSIDIARIES WERE ABSORBED BY HONOLULU UPON THE NONTAXABLE LIQUIDATION OF SAID SUBSIDIARIES.

The question involved in this appeal is the extent to which the stockholders of Honolulu must report as subject to federal income tax certain distributions paid by Honolulu to its stockholders during the calendar year 1936. Thus the appeal involves the taxes payable by the *stockholders* of Honolulu rather than the taxes payable by *Honolulu*. This distinction is of vital importance because the stockholders' taxes depend upon the *earnings or profits* of Honolulu available for dividends, whereas the corporation's taxes depend upon the *statutory net income* of Honolulu. The earnings or profits of the corporation available for dividends are of course entirely distinct from its statutory net income. For example, tax-exempt income is not included in statutory net income subject to tax, but does of course increase earnings or profits available for dividends. On the other hand, nondeductible items such as federal income taxes and capital losses will not reduce statutory net income but will obviously reduce earnings or profits available for dividends. The distinction between earnings or profits and statutory net income is more fully discussed hereinafter under II (a).

The question involved, therefore, is the extent to which the stockholders of Honolulu are subject to tax upon the distributions received by them in 1936. The gross income which is subject to the income tax, after the allowance of certain statutory deductions, is defined by section 22(a) of the Revenue Act of 1936 (Appendix, p. i) (the statute controlling the decision of this appeal) to include dividends, and the term dividends is defined by section 115(a) of the Act (Appendix, p. v) as a distribution out of the "earnings or profits" of a corporation, whether those of the taxable year or those accumulated since March 1, 1913. If a corporation declares dividends out of its earnings or profits, such dividends constitute income to the stockholders upon which they must pay taxes. On the other hand, if the corporation has no earnings or profits available for dividends, or if its dividends exceed the earnings or profits which are available, then to the extent that the dividends are not paid out of earnings or profits of the corporation such distributions do not constitute income to the stockholders and are received free from tax until such time as the tax-free distributions received exceed the cost of the stock to the stockholders.

(a) The principle established by the Sansome case and succeeding cases is that nontaxable reorganizations do not break the continuity of the corporate life as a continuing venture, with the result that under the doctrine of these cases it is held that the earnings or profits of the transferor corporation are transferred intact to the successor or transferee corporation.

Since the term "earnings or profits" is not defined by the statute, problems have arisen regarding the interpretation to be given this term. One of the earliest situations requiring judicial construction was that arising in connection with the tax-free transfer of the assets and business of one corporation to another corporation. In 1921 a New Jersey corporation transferred all its assets to a new corporation, which assumed the liabilities of the old corporation and issued its shares to the shareholders of the old corporation. Prior to its reincorporation the old corporation had a large earned surplus available for dividends, and if this corporation had paid dividends the stockholders would obviously have paid taxes thereon. After the reincorporation the new corporation paid dividends to its stockholders, who were identically the same persons as the stockholders of the old corporation, and these stockholders contended that the dividends were tax-free, since the new corporation had no earnings of its own available for dividends. The question thus presented came up for decision in the Circuit Court of Appeals for the Second Circuit in *Commissioner v. Sansome,* 60 Fed. (2d) 931 (1932), certiorari denied, 287 U. S. 667. That Court, in an opinion by Judge Learned Hand, held that the new corporation had *acquired the earnings of the old corporation* and the dividends were therefore subject to tax. The Court stated that the reincorporation was a nontaxable corporate reorganization under the express provisions of the statute making such reorganizations nontaxable, and came to the conclusion that nontaxable reorganizations do not break the continuity of the corporate life, saying:

> "Hence we hold that a corporate reorganization which results in no 'gain or loss' under Section 202(c)(2) (42 Stat. 230) *does not toll the com-*

> *pany's life as a continued venture* under Section 201, and that *what were 'earnings or profits' of the original, or subsidiary, company remain, for purposes of distribution, 'earnings or profits' of the successor, or parent, in liquidation."* (Italics added.)

Commissioner v. Sansome is the leading case on the subject of the transfer of corporate earnings from one corporation to another corporation in a nontaxable reorganization, the principle established by that case being known as the Sansome Rule.

Shortly after the decision of the Second Circuit Court of Appeals in *Commissioner v. Sansome* the same question arose in this Circuit in *United States v. Kauffmann,* 62 Fed. (2d) 1045 (1933). In that case the Union Lithograph Company, of San Francisco, which had a capital of $100,000 and an earned surplus of $419,258.12, transferred all its assets and liabilities to a new corporation, which issued its stock to the stockholders of the old corporation. On its books the new corporation credited $400,000 to capital stock and $119,258.12, the balance of the total capital and earned surplus of the old corporation, to paid-in surplus. After this reorganization and before the new corporation acquired any earnings or profits from its business, the new corporation declared a dividend, Kauffmann receiving $19,620, which he claimed did not constitute taxable income. The District Court, in an opinion by Judge St. Sure, rendered judgment for Kauffmann on the theory that the $19,620 was a distribution of the capital of the new corporation and not a dividend derived from earnings or profits.

On appeal, this Court first pointed out that the transaction by which the new corporation succeeded to all the assets and liabilities of the old corporation was a nontaxable reorganization, and then stated that the question involved was whether the earnings of the old corporation lost their character as such, when transferred to the new corporation, and became capital of the new corporation, or retained their character as earnings, so that a distribution thereof by the new corporation would be taxable. Kauffmann relied on the argument that the new corporation was a legal entity separate and distinct from the old corporation, and that therefore the earned surplus of the old corporation when transferred to the new corporation became a part of the capital of the new corporation. In deciding against this contention the Court relied on *Commissioner v. Sansome,* supra, which it said had decided that in a reorganization of this character there

> "was not such a change in corporate identity as prevented the new company from being considered as a *continuing venture* * * * and that whatever were earnings of the original corporation continued to be such in the hands of the new corporation." (Italics added.)

The principle that nontaxable reorganizations do not break the continuity of the corporate life as a continuing venture applies to consolidations of two or more corporations. In *Baker v. Commissioner,* 80 Fed. (2d) 813 (C.C.A. 2, 1936), where a parent corporation consolidated five wholly owned subsidiaries into a new company, it was held that the earnings of the five subsidiaries were transferred intact to the successor corporation.

Many cases could be cited in support of this principle, but no purpose would be served in multiplying citations since there are no cases to the contrary, and the Sansome Rule is now recognized as an established principle of income tax law. The principal cases are cited in par. 9.58 of Mertens' new twelve-volume work on the Law of Federal Income Taxation, published in the latter part of 1942. With respect to liquidations, Mertens states (Vol. I, pp. 507-8):

> "In a tax-free liquidation of a subsidiary into a parent corporation, the earnings or profits of the former are not considered distributed but simply transferred intact to the parent. The theory of continued identity of earnings obtains also where there is more than one transferor."

The tax-free liquidation of a subsidiary into a parent corporation was first permitted under the Revenue Act of 1936, which added subsection (6) to section 112(b) of the statute as it existed prior thereto.[3] The pertinent portion of this subsection reads as follows:

> "(6) **Property received by a corporation on complete liquidation of another.**—No gain or loss shall be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation." (Set forth in full, Appendix, p. i.)

[3]Section 110(a) of the Act of 1935 (49 Stat. 1020) made a similar amendment to the 1934 Act, but this amendment never was actually effective, since it was applicable only to taxable years beginning after December 31, 1935, and was superseded by the Revenue Act of 1936.

Section 112(b)(6) as thus enacted continued in the same form in the Revenue Act of 1938 and thereafter in the Internal Revenue Code.

After the Sansome Rule became recognized as an established principle of income tax law, the Treasury Regulations were amended to incorporate this principle. Regulations 94, issued under the Revenue Act of 1936, contains the following provision:

> "Art. 115-11. **Effect on earnings or profits on (of) certain tax-free exchanges and tax-free distributions.**—If, under the law applicable to the year in which any transfer or exchange of property after February 28, 1913, was made (including transfers in connection with a reorganization *or a complete liquidation under section 112(b)(6)* * * *), gain or loss was not recognized * * *, then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations." (Italics added.) (Set forth in full, Appendix, p. x.)

The foregoing regulation applies by its terms to transactions other than the complete liquidation of a subsidiary corporation, but with respect to the complete liquidation of a subsidiary corporation, which of course necessarily results in the dissolution of the subsidiary, it is obvious that the only "proper adjustment and allocation of the earnings or profits of the transferor" which can be made as between the transferor and transferee corporations is the transfer of all the earnings or profits of the subsidiary to the parent corporation. In this respect the regulation is but a recognition of the general principle referred to above as having been established by the cases, namely, that nontaxable reorganizations do not break the continuity of the corporate life as a continuing venture.

The quoted portion of Article 115-11 of Regulations 94 was continued without change in Regulations 101 relating to the Revenue Act of 1938 and Regulations 103 relating to the Internal Revenue Code. However, the following addition to Article 115-11 was made in 1938 by Regulations 101, and appeared immediately following the portion quoted above:

> "The general rule provided in section 115(b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:
>
> (1) * * *
>
> (2) The distribution in any taxable year (beginning before January 1, 1938, or on or after such date) of stock or securities, or other property or money, to a corporation *in complete liquidation of another corporation,* under the circumstances described in section 112(b)(6) of the Revenue Act of 1936 or section 112(b)(6) of the Revenue Act of 1938.
>
> (3) * * *
>
> (4) * * *
>
> A distribution described in paragraph (1), *(2),* (3) or (4) above does not diminish the earnings or profits of any corporation. In such cases, *the earnings or profits remain intact and available for distribution as dividends* by the corporation making such distribution, or *by another corpora-*

tion to which the earnings or profits are transferred upon such reorganization or other exchange." (Italics added.) (Set forth in full, Appendix, p. x.)

The addition thus made to the regulations in 1938 is merely a clarification of the portion of the regulation heretofore quoted (supra, p. 15) as it existed in 1936 and as continued in 1938. The portion of the regulation heretofore quoted could only mean, as applied to the complete liquidation of a subsidiary corporation, that the earnings or profits of the subsidiary would be transferred to the parent corporation. The addition made in 1938, quoted above, is more specific, and, as applied to the facts of our case, after stating that the distribution in liquidation by the three subsidiary corporations of Honolulu does not diminish the earnings or profits of the subsidiaries, continues with the statement that the earnings or profits remain intact and available for distribution as dividends by the corporation to which the earnings or profits are transferred, namely, Honolulu.

The addition to the regulations thus made in 1938 was continued without change in Regulations 103 as issued under the Internal Revenue Code.

Thus ever since the Revenue Acts have permitted the tax-free liquidation of subsidiaries, beginning with the year 1936, the regulations have provided that the earnings or profits of the subsidiaries remain intact and are transferred to the parent corporation. At the same time the regulations also contained the following provision:

> "Gains and losses within the purview of section 112 or corresponding provisions of prior Acts *are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section.*" (Italics added.)
>
> (See Article 115-3 of Regulations 94 and 101 and Section 19.115-3 of Regulations 103, Appendix, p. viii.)

Section 112 of the Revenue Act of 1936 referred to in this regulation permits "reorganizations" as therein defined (section 112(g), Appendix, p. iv) to be consummated without incurring income tax. This provision of the regulations is a companion provision to the provision referred to above (Article 115-11), and is part of the same general plan adopted by the regulations to synchronize the effect of tax-free reorganizations upon *earnings or profits,* available for dividends, as distinguished from taxable net income. As applied to the liquidation of subsidiaries, for example, if a subsidiary had an earned surplus and its liquidation resulted in a profit to the parent, it is obvious that the earned surplus of the parent should not be increased by *both* the earned surplus of the subsidiary and the profit which is actually *realized* by the parent, although not *recognized* for tax purposes. Thus the regulations provide that the earned surplus will be transferred, but on the other hand realized profit (not recognized under section 112 as subject to tax) will not be taken into account in the computation of earnings or profits available for dividends.

What is the result if the subsidiary has an operating deficit and its liquidation results in a loss to the parent corporation?

(b) Under the doctrine of the Sansome case, that the continuity of the corporate life as a continuing[4] venture is not broken, no valid distinction can be drawn between operating deficits on the one hand and earnings or profits on the other hand.

Before discussing the effect of an operating deficit in the transferor corporation, the meaning of the terms "earnings available for dividends" and "operating deficit" must be clearly understood. A corporation has earnings available for dividends if its profits, after deducting dividends declared out of profits, exceed its losses. In such case the balance of its earned surplus account will appear on the right-hand or credit side. Since the earned surplus account normally appears on the right-hand or liability side of the balance sheet, together with capital stock, paid-in surplus, and other "net worth" accounts, an earned surplus account with a balance on the right or credit side would be said to have a positive rather than a negative balance. On the other hand, a corporation has an operating deficit if its operating losses exceed its profits after deducting dividends declared out of the profits. In this case the balance in its earned surplus account will appear on the left-hand or debit side. Such a balance would be said to be a negative balance in the earned surplus account.

It will perhaps be helpful to illustrate the foregoing by the following simple examples:

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[4]Judge L. Hand in the *Sansome* case uses the word "continued", whereas Judge Wilbur in the *Kauffmann* case changed the word to "continuing".

Assume that the X Company had earnings available for dividends on January 1, 1936, in the amount of $200,000, that its profits for 1936 were $50,000, and that it declared two $10,000 dividends during the year. Its earned surplus account would then appear as follows:

X Company

Earned Surplus

1936			1936		
June 1	Dividend	10,000	Jan. 1	Balance	200,000
Dec. 1	Dividend	10,000	Dec. 31	Profits, 1936	50,000
Dec. 31	Balance	230,000			
		250,000			250,000
			1937		
			Jan. 1	Balance	230,000

On the other hand, assume that the Y Company had an operating deficit on January 1, 1936, in the amount of $100,000, and that its earnings for 1936 were $60,000. Its earned surplus account would then appear as follows:

Y Company

Earned Surplus

1936			1936		
Jan. 1	Balance	100,000	Dec. 31	Profits, 1936	60,000
			Dec. 31	Balance	40,000
		100,000			100,000
1937					
Jan. 1	Balance	40,000			

It will be seen that the balance of the earned surplus account of Y Company on January 1, 1936, appeared on the left-hand or debit side, indicating that it had no earned surplus but on the contrary an operating deficit in the amount of $100,000. It thus had a negative balance in its earned surplus account. It will also be seen that the profits for 1936 in the amount of $60,000 operated to reduce this negative balance or operating deficit to the amount of $40,000, the balance appearing on January 1, 1937. This negative balance cannot be disregarded or charged to some other account, but must be carried in the *earned surplus* account, in order that the books will clearly indicate at what point subsequent profits have eliminated this adverse balance, after which additional profits will constitute earnings available for dividends. An operating deficit must be eliminated by subsequent earnings before there can be accumulated earnings or profits available for dividends (except that dividends may be paid from the current earnings of the taxable year). All the cases recognize this principle as basic. See for example,

> *Commissioner v. W. S. Farish & Co.,* 104 Fed. (2d) 833 (C.C.A. 5, 1939).

Thus the earned surplus account of a corporation constitutes an historical record of a corporation's annual profits and losses and the dividends which have been declared at such times as there were earnings available for dividends. The negative balances which may exist in this account from time to time, at which time the account will have an operating deficit, are just as much a part of this historical record as the positive balances indicating earnings available for dividends.

To complete the picture we will assume that the following two balance sheets represent the condition of the X Company and the Y Company on January 1, 1936:

X Company

Balance Sheet, January 1, 1936

Assets		Liabilities	
Cash	5,000	Earned Surplus	200,000
Real Estate & Plant	1,495,000	Capital stock	1,300,000
	1,500,000		1,500,000

Y Company

Balance Sheet, January 1, 1936

Assets		Liabilities	
Cash	5,000	Earned Surplus	100,000
Real Estate & Plant	1,195,000	Capital Stock	1,300,000
	1,200,000		1,200,000

It will be seen that the earned surplus of the X Company appears in the foregoing balance sheet as a positive or black figure, whereas the earned surplus of the Y Company appears as a negative or red figure. As has been heretofore stated, under the doctrine of the *Sansome* case as set forth in numerous judicial decisions and as incorporated in the Treasury regulations, it is certain that upon the liquidation of a subsidiary corporation its earnings or profits are transferred to the parent corporation. Can any distinction be drawn between earnings and profits which, as we have seen, represent a positive balance in the earned surplus account, and an operating deficit, which is a negative balance in the earned surplus account?

In the present case the three wholly owned subsidiaries of Honolulu had total operating deficits in the amount of $1,205,451.61, and Honolulu realized a loss upon the liquidation of these subsidiaries in the amount of $1,225,908.63 (the slight difference in these figures is explained in the footnote on page 5). It is apparent that the earned surplus of Honolulu should not be reduced by both the loss which it realized upon the dissolution of these subsidiaries and the total operating deficits of the subsidiaries, since this would be a duplication of the same loss. It is also apparent that in order to avoid a substantial overstatement of the earned surplus of Honolulu it is necessary to reduce its earned surplus either by the loss realized or by the operating deficits of the subsidiaries.

Article 115-3 of the regulations (supra p. 18) specifically refers to losses as well as gains, and provides that the loss realized by Honolulu will not reduce the earnings and profits of Honolulu because it was not recognized for tax purposes under section 112.[5] On the other hand, the companion provision of the regulations, namely, Article 115-11 (supra, p. 16), refers only to the transfer of the earnings or

[5]Although the decided cases do not agree with this Article, it has received statutory recognition. See the discussion under II (b) and (c), infra.

profits and not to the transfer of an operating deficit. These two articles, being part of the same general plan to synchronize the effect of tax-free reorganizations upon earnings or profits, must be read together. In view of the fact that Article 115-3 refers to losses as well as gains, it is quite possible that Article 115-11 should be interpreted to include operating deficits within the meaning of the words "earnings or profits". As we have seen, an operating deficit is but a negative balance in the earned surplus account, and such an interpretation would not be unreasonable.

We are merely suggesting but not insisting upon such an interpretation, since it is possible that the Treasury Department did not intend to go beyond the decided cases in promulgating this regulation. When the regulations first incorporated a provision relating to the transfer of earnings from one corporation to another in a nontaxable reorganization, which, as we have heretofore seen, occurred in 1936, the doctrine of the *Sansome* case had already become firmly established. The doctrine was recognized and discussed in Paul and Mertens' authoritative work on the Law of Federal Income Taxation (par. 8.45), which was published in 1934, but the doctrine of the *Sansome* case was not incorporated in Regulations 86, which appeared in 1935, and it was not until Regulations 94 were adopted in 1936 that this doctrine made its appearance in the provisions of Article 115-11 to which we have referred above. Thus the regulations merely followed the decided cases, which have dealt only with transferor corporations having earnings.

None of the cases thus far decided has dealt with an operating deficit, and it is possible, therefore, that the Treasury Department is waiting for decisions on this subject before expanding its regulations to definitely include operating deficits as well as earnings.

Since the principle upon which the transfer of earnings in a tax-free reorganization is based is that the *continuity of the corporate life as a continuing venture is not broken,* it is obvious that no logical distinction can be drawn between earnings and operating deficits. There is no magic in the figure being black rather than red. Suppose, for example, that X Company and Y Company, whose earned surplus accounts have been set forth above (p. 20), were to reorganize by means of a nontaxable statutory merger. If in such case Y Company was the continuing corporation and therefore did not cease to exist, its operating deficit in the amount of $100,000 would obviously not disappear but would continue on its books. On the other hand, the earnings of X Company in the amount of $200,000 would be transferred intact to Y Company in accordance with the Sansome Rule. Thus the earned surplus of the combined companies after the merger would show earnings available for dividends in the amount of $100,000, which would consist of the earnings of X Company less the operating deficit of Y Company.

If, on the other hand, X Company was the continuing corporation, then its surplus of $200,000 would of course continue on its books. But the parties to this proceeding differ as to the treatment to be accorded the operating deficit of Y Company. It is our contention that, in accordance with the principle of the Sansome Rule that the continuity of the life of Y Company as a continuing venture is not broken, the operating deficit of Y Company would be transferred to X Company, thus reducing the earnings available for dividends of the combined corporations to $100,000, and producing the same result as though Y Company had been the continuing corporation. On the other hand, the Government, in attempting to make a distinction between operating deficits and earnings or profits, would contend that the operating deficit of Y Company would *not* be transferred to X Company in the merger, with the result that the combined corporations would have earnings of $200,000 available for dividends. Thus the Government is forced into the position of contending *that a different result obtains, depending upon whether X Company or Y Company is the continuing corporation.* The results of tax-free mergers should certainly not depend upon such insubstantial differences.

Taking an illustration more closely paralleling the facts of the instant case, let us suppose one of the wholly owned subsidiaries of Honolulu had had earnings of $1,000,000 and the remaining two subsidiaries had total operating deficits of $2,205,451.61, making a net operating deficit for the three subsidiaries of $1,205,451.61, which is the actual total operating deficit of the three wholly owned subsidiaries that were liquidated. In such case Honolulu would have sustained the same loss on the liquidation of the three subsidiaries as it actually sustained upon the liquidation of its three wholly owned subsidiaries in 1936, and this loss would have been substantially the same as the net operating deficits of the three subsidiaries in the total amount of $1,205,451.61. However, the Government, in accordance with the distinction that it attempts to make, would transfer the earned surplus of one of the subsidiaries, in the total amount of $1,000,000, but would refuse to permit the transfer of the operating deficits of the two other subsidiaries, in the amount of $2,205,451.61. Thus the earnings of Honolulu available for dividends would be *increased* by the amount of $1,000,000, whereas they should actually be *decreased* by the amount of $1,205,451.61. Not only is this result completely erroneous, but it is entirely illogical as well.

The illogical results to which the Government is forced in the two foregoing illustrations could be avoided by simply recognizing that earnings and operating deficits are both balances of the same account —one positive, the other negative. The illogical results flow from the Government's insistence on splitting the account down the middle and insisting that balances on one side of the middle are to be treated differently from balances on the other side.

To say that the earnings of the transferor corporation in a nontaxable reorganization are transferred intact to the successor corporation, but that this principle does not apply to operating deficits, is to confuse the *result* of the Sansome Rule, as such result has thus far appeared in the decided cases, which have dealt only with corporations having an earned surplus, with the basic principle decided by the *Sansome* case, which principle has been reiterated in substantially all the later decisions which have passed upon this question. This basic principle is that in a tax-free reorganization *the continuity of the corporate life as a continuing venture is not broken.* This means that the entire taxable status of the corporation remains the same, that is to say, the basis of its assets, its reserves for depreciation and depletion, the status of its earned surplus account, whether a positive balance, indicating earnings available for distribution, or a negative balance, indicating an operating deficit, all these items and others of a similar character would be carried forward unchanged, some by specific statutory provisions, others by judicial construction through the application of the Sansome Rule. Thus the transfer of earnings in a corporate reorganization *is but one result of this basic principle,* and it is at once apparent that it is entirely illogical to assert, as the Government does, that the operating deficit of a corporation is in a different category from its earnings and will not be transferred to a successor corporation in accordance with the doctrine of the *Sansome* case.

Mertens in his new work on the Law of Federal Income Taxation states (Vol. I, p. 510):

> "Although there are no cases in point, the conclusions expressed above (relating to the transfer of earnings) would seem, if correct, to apply to the absorption of deficits of predecessor corporations as well as of surplus."

In conclusion, on this phase of the argument, it is recognized that the application of the Sansome Rule to *all* cases of tax-free reorganizations may also lead to illogical results—but if so, the results will be equally illogical whether operating deficits or earnings are involved. In other words, the illogical nature of these results will not be caused by treating operating deficits in the same manner as earnings, but rather may result from the application of the Sansome Rule to all cases of tax-free reorganizations. Mertens in the work just cited recognizes this possibility, and suggests that the test as to whether earnings are transferred to the successor corporation should not be the "tax-free" character of the so-called reorganization, stating that (Vol. I, p. 510):

> "any such general test would confuse the issue and give rise occasionally to absurd results in the various types of situations arising under our complex exchange and reorganization provisions. The proper test is whether there is substantial identity of the several corporations and continuity of proprietary interests."

This theory of Mertens is commented upon merely for the purpose of pointing out that even under this narrower application of the Sansome Rule, not adopted in any of the decided cases, the principle of the *Sansome* case would apply to the facts of the instant case. The three subsidiaries of Honolulu which were liquidated in 1936 were at all times wholly owned subsidiaries of Honolulu, and thus there was clearly "substantial identity of the several corporations and continuity of proprietary interests".

The argument that the operating deficits of these subsidiaries were absorbed by Honolulu applies, of course, with equal force to the acquisition by one of these subsidiaries, California Exploration Company, Inc., of the operating deficits of its two predecessors, also at all times wholly owned subsidiaries of Honolulu, which were carried forward on to the books of California Exploration Company, Inc. in the non-taxable consolidation which occurred in 1934. (See Statement of the Case, supra, p. 4.)

Our brief up to this point has been devoted exclusively to the argument that the operating deficits of the subsidiaries were absorbed by Honolulu. If we have established this point, and we believe that we have conclusively done so, it follows that Honolulu had no earnings during the calendar year 1936, and its distributions in that year were distributions of capital except to the extent set forth in footnote 2, supra, p. 6.

It is only in the event that the Court should conclude that the operating deficits of the subsidiaries were not absorbed by Honolulu that the alternative contention which we are about to discuss requires consideration.

II.

IF IT IS HELD THAT THE OPERATING DEFICITS OF SAID SUBSIDIARIES WERE NOT ABSORBED BY HONOLULU, THEN IT IS CONTENDED IN THE ALTERNATIVE THAT THE LOSS REALIZED BY HONOLULU UPON THE LIQUIDATION OF SAID SUBSIDIARIES REDUCED THE EARNINGS OF HONOLULU AVAILABLE FOR DIVIDENDS.

Honolulu sustained an admitted loss of $1,225,-908.63 on the liquidation of its three wholly owned subsidiary corporations on August 31, 1936. The liquidation of these subsidiary corporations was carried out under the provisions of section 112(b)(6) of the Revenue Act of 1936 and was therefore nontaxable—that is to say, that neither gain nor loss was recognized in the determination of the *statutory net income* of Honolulu subject to income tax, as distinguished from its earnings or profits available for dividends.

(a) The term "earnings or profits" is not synonymous with statutory net income.

The fact that the liquidations were nontaxable transactions—that is, that Honolulu realized neither gain nor loss in so far as its *taxable net income* is concerned—does not necessarily mean that the loss realized thereon does not reduce the earnings of Honolulu available for dividends. The income tax statutes contain no definition of the words "earnings or profits" which are the source from which taxable dividends must be declared. That these words are not synonymous with the net income subject to taxation has been universally recognized ever since the passage of the first income tax statute. Thus, for example, dividends received by one corporation on the stock which it owns in another corporation were for years entirely exempt from tax and therefore not included in the net income reported by the corporation receiving the dividends. Nevertheless, such dividends obviously increase earnings available for dividends of the recipient corporation. The same is true of any form of tax-exempt income. Many corporate expenses are also disallowed for income tax purposes, such as expenses which are not ordinary or necessary, salaries in an unreasonable amount, contributions in excess of a certain percentage of the net income, and federal income taxes. However, in all such cases it has always been recognized that the amount of the deductions which are not allowable in the calculation of net income subject to tax nevertheless do reduce earnings available for dividends.

A more apt illustration is perhaps the treatment accorded losses from sales of capital assets. Corporations have in the past been permitted a deduction for such losses only to the extent of $2000, and at the present time a deduction for losses from the sale of capital assets is not permitted at all, but such losses may only be used by corporations as an offset against similar gains. But there has never been any question that such losses reduce the earnings of a corporation available for dividends.

The distinction between taxable net income and earnings or profits was clearly stated in an early decision of the Board of Tax Appeals, *Charles F.*

Ayer, 12 B.T.A. 284, 287 (1928). An often quoted extract from that opinion reads as follows:

> "Dividends and (on) stock of domestic corporations, interest on bonds and obligations of States and municipalities, and statutory exemptions are not a part of the statutory net income of a corporation, but are nevertheless a part of its earnings or profits and may form a part of ordinary dividends which are taxable when received by the stockholders. On the other hand, corporations frequently make expenditures which are not deductible from gross income for income-tax purposes, but which nevertheless reduce earnings or profits. It therefore follows that the earnings or profits mentioned in section 201 (a) of the Revenue Act of 1921 are not the equivalent of the taxable net income of the corporation."

Thus the mere fact that the loss sustained by Honolulu upon the liquidation of its wholly owned subsidiaries in 1936 was not deductible for income tax purposes does not mean that it was not deductible in the computation of the earnings of Honolulu available for dividends; in fact, in the absence of some specific statutory provision (and such provision was not enacted until 1940[6]) it would seem that all losses sustained by a corporation necessarily reduce its earnings which are available for dividends. As the Third Circuit Court of Appeals stated in *Commissioner v. F. J. Young Corporation,* 103 Fed. (2d) 137, 139 (1939):

> "Section 115(a) is simply a definition of the word 'dividend' and merely distinguishes be-

[6]See discussion under subhead (c), infra.

tween a distribution out of 'earnings and profits' and a distribution out of capital. *The words 'earnings or profits',* as therein used, *are words in common use, and 'are to be given their natural, plain, ordinary, and commonly understood meaning'.*" (Italics added.)

(b) In the determination of earnings or profits available for dividends it is not material that the loss realized by Honolulu upon the liquidation of its subsidiaries occurred in a tax-free transaction and was not recognized for income tax purposes.

The Board of Tax Appeals and the Courts have decided in a series of cases, there being no decisions to the contrary, that gains or losses realized in tax-free transactions which do not affect statutory net income, nevertheless increase or decrease earnings or profits available for dividends. The leading case on this subject is *Commissioner v. F. J. Young Corporation,* 103 Fed. (2d) 137 (C.C.A. 3, 1939), affirming 35 B.T.A. 860 (1937).

In that case Corporation A exchanged certain property which had a cost basis of $36,000 for stock of another corporation which had a market value of $957,000, thus realizing a profit of $921,000. This exchange was a nontaxable transaction carried out under the provisions of section 112(b)(5) of the Revenue Act of 1928 (45 Stat. 816), and thus the realized gain was not recognized for income tax purposes. Thereafter Corporation A declared a substantial dividend to its stockholders, of whom the Young Corporation was one. The earnings of Corporation A, apart from the unrecognized gain of $921,000 referred to above, were not sufficient to cover this distribution, and the Government therefore contended that the distribution was a dividend only to the extent of such earnings, the balance being applied in reduction of the basis of Corporation A's stock owned by the Young Corporation and taxable to the extent that the gain exceeded such basis. Since intercorporate dividends were at that time fully exempt from tax, the Young Corporation contended that the profit of $921,000, although not recognized for income tax purposes, *nevertheless increased the earnings or profits of Corporation A,* and consequently such earnings or profits were sufficient to cover the distribution.

Both the Board of Tax Appeals and the Circuit Court of Appeals held that the profit of $921,000 realized by Corporation A increased its earnings or profits available for dividends, and that it was immaterial that this profit occurred in a nontaxable transaction and was not recognized for income tax purposes. The Circuit Court of Appeals in its opinion said:

> "The infirmity in the commissioner's reasoning lies in the falsity of his major premise, namely, that a gain which is not 'recognized' under section 112 (b) (5) may not be considered as 'earnings or profits' under section 115 (a).
>
> It cannot be doubted that a corporation which has acquired certain property for $36,000, and later trades or exchanges it for other property worth $957,000, *has made a profit within the ordinary sense of the term,* for a profit is generally understood as 'the excess of what is obtained over the cost of obtaining it'. 50 C. J. 644; Hentz v.

> Pennsylvania Company for Insurance on Lives, etc., 134 Pa. 343, 19 A. 685. Therefore, as a result of the exchange of securities mentioned above, Yeager realized a definite 'gain' or 'profit' and the fact that the revenue act failed to 'recognize' that as a taxable 'gain' could not alter the situation. (Italics added.)
>
> The very wording of section 112 (b) indicates that Congress was aware of the distinction between net income and *taxable* net income for the provision that certain 'gains' or 'profits' should not be 'recognized' in computing taxable income, shows that Congress realized that as commonly understood they were nevertheless 'gains' and 'profits'."

Other cases to the same effect are:

Commissioner v. McKinney, 87 Fed. (2d) 811 (C.C.A. 10, 1937), affirming 32 B.T.A. 450 (1935);

Susan T. Freshman, 33 B.T.A. 394, 401 (1935) (appeals dismissed C.C.A. 2, November 17, 1936, and C.C.A. 3, November 27, 1936);

Robert McCormick, Executor, 33 B.T.A. 1046, 1060 (February, 1936);

Commissioner v. W. S. Farish & Co., 104 Fed. (2d) 833 (C.C.A. 5, 1939), affirming 38 B.T.A. 150 (1938);

Dorothy W. Elmhirst, 41 B.T.A. 348 (1940).

It is admitted that Honolulu realized a loss of $1,225,908.63 upon the liquidation of the three subsidiary corporations in 1936. (Statement of the Case, supra, p. 5.) Although this transaction was carried out under the provisions of section 112(b)(6) of the

1936 Act and therefore the loss was not recognized for income tax purposes, it is clear, in view of the foregoing authorities, that this loss nevertheless reduced earnings or profits available for dividends. But the Government contends that in spite of the foregoing decisions, and there has not been a case to the contrary, the loss realized by Honolulu *does not* reduce its earnings or profits, because Congress more than four years later amended the statute so as to overcome the effect of the foregoing decisions. It remains, therefore, to consider the effect of the amendment made by the Second Revenue Act of 1940.

(c) The attempted retroactive application of section 501 of the Second Revenue Act of 1940 violates the due process clause of the Constitution.

As has just been stated, such cases as had passed upon the question were unanimously to the effect that gains and losses realized by corporations in nontaxable transactions, and which were not recognized for income tax purposes, nevertheless increased or decreased earnings or profits available for dividends. These decisions were contrary to a sentence appearing in Article 115-3 of the regulations to which we have previously referred (supra, p. 18), which provided that gains or losses are brought into the earnings and profits at the time and to the extent such gains and losses are recognized for income tax purposes. Section 501 of the Second Revenue Act of 1940 (Appendix, p. v) converts this regulation into a statutory provision. This section of the statute added subsection (l) to section 115 of the Internal Revenue Code, the pertinent portion reading as follows:

> "Gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation * * * shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made."

The foregoing amendment to the Internal Revenue Code was made applicable by section 501(b) to taxable years beginning after December 31, 1938, which is the effective period of the Internal Revenue Code. However, subsection (c) of section 501 purports to make the amendment effective as though it were a part of each of the Revenue Acts *for all taxable years* prior to the Internal Revenue Code.

In discussing the foregoing amendment the Report of the Senate Finance Committee (76th Congress, 3rd Session, Report No. 2114, p. 25) states:

> "The requirement of section 501 that there shall be no increase or decrease in earnings and profits by reason of a wholly unrecognized gain or loss *is but another aspect of the principle under which the earnings and profits of the transferor become by reason of the transfer the earnings and profits of the transferee.*" (Italics added.)

The principle referred to in the foregoing quotation is of course the doctrine of the *Sansome* case, and it is thus apparent that Congress had decided to incorporate into the statute the provision of the regulations (Article 115-3) which the Board and the

Courts had refused to follow, in order to consummate the general plan of the regulations (heretofore referred to supra, p. 18) to synchronize the effect of tax-free reorganizations upon earnings or profits available for dividends. No doubt Congress expected this plan, which would synchronize the treatment of unrecognized gains or losses on the one hand, with the transfer of earnings in nontaxable reorganizations on the other hand, to produce an equitable result in all cases, otherwise it would hardly have provided that the amendment should operate retroactively *for all taxable years.* And perhaps it would produce an equitable result in all cases—at least it would in so far as the present cases are concerned—if the doctrine of the *Sansome* case applies, as we believe we have conclusively established, to operating deficits as well as to earnings. If operating deficits are not included within the doctrine of the *Sansome* case, it is difficult to perceive why this amendment included within its scope unrecognized *losses* as well as gains. For example, in the instant case this amendment prohibits the reduction of the earnings of Honolulu available for dividends by an *admitted loss actually realized* in the amount of approximately $1,225,000. The only possible justification for such a result is that an equivalent reduction in earnings is obtained by the application of the principle of the *Sansome* case to the operating deficits of the subsidiaries. But if it is held that the Sansome Rule is to be limited to the carrying forward of earnings, and does not apply to the carrying forward of an operating deficit, then the planned synchronization to which we have referred fails and the statute is inequitable. In such case it is contended that the retroactive application of the amendment made by section 501(a) of the Second Revenue Act of 1940, as provided by section 501(c), to a transaction occurring more than four years prior thereto, is confiscatory and invalid and a violation of the due process clause of the Fifth Amendment of the Constitution of the United States.

It is recognized that retroactive income taxes have been sustained as constitutional where their retroactivity is limited to the taxable year in which the statute is passed, or even to the preceding year already closed. Thus in *United States v. Hudson,* 299 U.S. 498 (1937), the Supreme Court said:

> "As respects income tax statutes, it long has been the practice of Congress to make them retroactive for relatively short periods so as to include profits from transactions consummated while the statute was in process of enactment, or within so much of the calendar year as preceded the enactment; and repeated decisions of this Court have recognized this practice and sustained it as consistent with the due process of law clause of the Constitution."

And in *White Packing Company v. Robertson,* 89 Fed. (2d) 775 (C.C.A. 4, 1937), it was held that the Act of Congress approved June 22, 1936, imposing the so-called "windfall tax", was valid, although applying to income received during the taxable year 1935, so as to be retroactive for a maximum period of about sixteen months.

It is obvious, of course, that no question of constitutionality can arise with respect to retroactive amendments that are of benefit to taxpayers, such as the allowance of non-business expenses incurred in the production of income, and the elimination from gross income of recoveries of bad debts which had previously been deducted in loss years. Both of these amendments were enacted by the Revenue Act of 1942 (sections 121 and 116, respectively) (56 Stat. 812, 819) and were made retroactive under all prior statutes.

But with respect to amendments which are a burden to the taxpayer, the cases uniformly set forth the principle, illustrated by the two cases cited, that income tax amendments may be made retroactive for a period that is "recent". As to what is "recent", it would appear from the cases that the entire calendar year preceding the year of enactment of the statute—that is to say, a maximum period of twenty-four months—would be held to be recent.

One case has been found which sets forth an exception to this principle. This is the case of *Wilgard Realty Company, Inc. v. Commissioner,* 127 Fed. (2d) 514 (C.C.A. 2, 1942). This case passed upon the constitutionality of section 213(f) of the Revenue Act of 1939 (53 Stat. 871), by which an amendment made by section 213 of that Act was made applicable to taxable years ending after December 31, 1923. The Supreme Court of the United States had held in *United States v. Hendler,* 303 U. S. 564 (1938), that the assumption of the liabilities of a corporate party to a tax-free reorganization destroys the nontaxable character of the reorganization, gain being recognized to the extent of the assumption. The amendments made by section 213 of the 1939 Act were made to overcome the effect of the Supreme Court decision and to permit the assumption by one corporation of the debts of the other in the process of reorganization. The taxpayer in the *Wilgard* case had acquired certain real estate in 1932 from an individual in exchange for all the taxpayer's stock, together with the assumption of the individual's liability on a debt secured by a mortgage on the real estate. The taxpayer sold this real estate in 1937, and contended that in computing its gain or loss on this sale it was not limited to the cost of the real estate to the individual transferor, as it would be if the exchange which occurred in 1932 was tax-free. The exchange was tax-free if the amendments made by section 213 of the 1939 Act could be applied retroactively, but the taxpayer contended that the retroactive provisions of section 213(f) of the Act violated the Fifth Amendment of the Constitution.

In discussing the extent to which an income tax statute may be retroactive in its operation, the Court said (p. 517):

> "Sometimes the extent of permissible retroactivity can be measured with sufficient certainty in terms of time. As for instance, the 'recent transactions' as to which a retroactive tax law might be valid under Cooper v. United States, 280 U. S. 409, 411, 50 S. Ct. 164, 74 L. Ed. 516, were in Welch v. Henry, supra, at page 150 of 305 U. S., at page 127 of 59 S. Ct., 83 L. Ed. 87, 118 A. L. R. 1142, 'taken to include the receipt of income during the year of the legislative session preceding that of its enactment'. Taxpayers must

> expect that fundamental changes in tax laws may be made at any time in a taxable period to be effective for the entire period and in addition for some time previously, as the above cases show. That is to say, retroactivity in taxation which would otherwise be so arbitrary as to be unconstitutional may escape such disability if it is not too great in point of time."

However, the taxpayer in the *Wilgard* case undoubtedly believed when it acquired the real estate in 1932 that the transaction was tax-free, contrary to the contention which it was advancing, since no case prior to the decision of the Supreme Court in the *Hendler* case in 1938 had held that such a transaction was taxable because of the assumption of liabilities. The Court considers the effect of this situation in the following language (p. 517):

> "Sec. 213(f)(1) of the Revenue Act of 1939 was in terms made applicable to exchanges 'occurring in a taxable year ending after December 31, 1923, and beginning before January 1, 1939'. Its possible backward effect is, indeed, long and in this instance was about seven years. There is no reason, nevertheless, to believe that the petitioner made the exchange in 1932 in the belief that its assumption of the mortgage indebtedness kept the exchange from being a tax free one. On the contrary it is but a fair deduction from the undisputed facts that the petitioner believed the exchange was, when it occurred, the tax free one that the 1939 enactment made it."

The Court then sustained the retroactive effect of the amendment as constitutional, on the ground that the taxpayer understood at the time the transaction was entered into that the effect would be no different *than that made by the retroactive amendment.* As the Court said (p. 517), "the decisive test in this instance is whether this taxpayer has had its expectations as to taxation unreasonably disappointed".

In the Report of the Ways and Means Committee of the House of Representatives (76th Congress, 1st Session, Report No. 855), the Committee on page 20 gives practically the same reason for making the amendment discussed in the *Wilgard* case retroactive as that referred to by the Court as justifying the retroactive application of the amendment. The Committee said, page 20:

> "Since transactions entered into under such Acts (Acts of 1924 to 1938, inclusive) were made under the understanding of the law that such assumptions of, and taking subject to, liabilities did not give rise to recognizable gain, *it is necessary, in order to prevent hardship on taxpayers and to prevent tax avoidance, to provide retroactively for the application of the rules above provided.*" (Italics added.)

However, the situation with respect to the retroactive application of the amendment made by section 501 of the Second Revenue Act of 1940 is directly the reverse of that which existed in the amendment discussed in the *Wilgard* case. The appellant in the instant case had no reason to suppose that the loss realized by Honolulu in 1936 upon the liquidation of its subsidiaries would not reduce earnings or profits available for dividends. The decisions of the Board of Tax Appeals as they existed at that time were uniformly to the effect that gains or losses incurred in tax-free transactions and not recognized for income tax purposes would nevertheless increase or decrease earnings or profits available for dividends. See the discussion under heading II (b), supra, and the cases therein cited.

In view of the foregoing authorities it would seem that section 501(b) of the Second Revenue Act of 1940, making the amendment to the Internal Revenue Code contained in section 501(a) retroactive for the effective period of the Code, that is to say, to January 1, 1939, covers a period which is "recent" and is therefore a proper exercise of the legislative power. With respect to section 501 (c), however, which purports to make the amendment operative *for all prior years,* if it should be held that the operating deficits of its subsidiaries were not transferred to Honolulu, then it is contended that a serious inequity results and that section 501 (c) is confiscatory in so far as this appellant is concerned, and in violation of the due process clause of the Constitution.

CONCLUSION.

The doctrine of the *Sansome* case is peculiarly applicable to the nontaxable liquidation of the three wholly owned subsidiaries of Honolulu because they meet the suggested narrower test of substantial identity of the several corporations and continuity of proprietary interests. Since under this doctrine the continuity of the life of the subsidiaries is not broken, it irresistibly follows that the operating deficits of the subsidiaries were absorbed by Honolulu.

It is only in the event the Court does not concur in the foregoing contention, that the attempted retroactive application of section 501(a) of the Second Revenue Act of 1940 produces an inequitable result and is attacked as unconstitutional. All the cases agree in holding that the loss admittedly sustained by Honolulu reduces its earnings available for dividends. The attempt to overcome the effect of these decisions by a statute enacted more than four years after the loss was incurred is a violation of the due process clause of the Constitution.

Dated, San Francisco,
February 11, 1944.

Respectfully submitted,
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(Appendix Follows.)

Appendix.

Appendix

STATUTORY PROVISIONS.

Revenue Act of 1936, Section 22(a) (49 Stat. 1657).

(a) General Definition.—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. In the case of Presidents of the United States and judges of courts of the United States taking office after June 6, 1932, the compensation received as such shall be included in gross income; and all Acts fixing the compensation of such Presidents and judges are hereby amended accordingly.

Revenue Act of 1936, Section 112(b)(6) (49 Stat. 1680).

(6) Property Received by Corporation on Complete Liquidation of Another.—No gain or loss shall be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation. For the purposes of this paragraph a distribution shall be considered to be in complete liquidation only if—

(A) the corporation receiving such property was, on the date of the adoption of the plan of liquidation, and has continued to be at all times until the receipt of the property, the owner of stock (in such other corporation) possessing at least 80 per centum of the total combined voting power of all classes of stock entitled to vote and the owner of at least 80 percentum of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends), and was at no time on or after the date of the adoption of the plan of liquidation and until the receipt of the property the owner of a greater percentage of any class of stock than the percentage of such class owned at the time of the receipt of the property; and

(B) no distribution under the liquidation was made before the first day of the first taxable year of the corporation beginning after December 31, 1935; and either

(C) the distribution is by such other corporation in complete cancellation or redemption of all its stock, and the transfer of all the property occurs within the taxable year; in such case the adoption by the stockholders of the resolution under which is authorized the distribution of all the assets of such corporation in complete cancellation or redemption of all its stock, shall be considered an adoption of a plan of liquidation, even though no time for the completion of the transfer of the property is specified in such resolution; or

(D) such distribution is one of a series of distributions by such other corporation in complete cancellation or redemption of all its stock

> in accordance with a plan of liquidation under which the transfer of all the property under the liquidation is to be completed within three years from the close of the taxable year during which is made the first of the series of distributions under the plan, except that if such transfer is not completed within such period, or if the taxpayer does not continue qualified under subparagraph (A) until the completion of such transfer, no distribution under the plan shall be considered a distribution in complete liquidation.

If such transfer of all the property does not occur within the taxable year the Commissioner may require of the taxpayer such bond, or waiver of the statute of limitations on assessment and collection, or both, as he may deem necessary to insure, if the transfer of the property is not completed within such three-year period, or if the taxpayer does not continue qualified under subparagraph (A) until the completion of such transfer, the assessment and collection of all income, war-profits, and excess-profits taxes then imposed by law for such taxable year or subsequent taxable years, to the extent attributable to property so received. A distribution otherwise constituting a distribution in complete liquidation within the meaning of this paragraph shall not be considered as not constituting such a distribution merely because it does not constitute a distribution or liquidation within the meaning of the corporate law under which the distribution is made; and for the purposes of this paragraph a transfer of property of such other corporation to the taxpayer shall not be considered as not constituting a distribution (or one of a series of distributions) in complete cancellation or redemption of all the stock of such other corporation, merely because the carrying out of the plan involves (i) the transfer under the plan to the taxpayer by such other corporation of property, not attributable to shares owned by the taxpayer, upon an exchange described in paragraph (4) of this subsection, and (ii) the complete cancellation or redemption under the plan, as a result of exchanges described in paragraph (3) of this subsection, of the shares not owned by the taxpayer.

Revenue Act of 1936, Section 112(g) (49 Stat. 1682).

(g) Definition of Reorganization.—As used in this section and section 113—

(1) The term "reorganization" means (A) a statutory merger or consolidation, or (B) the acquisition by one corporation in exchange solely for all or a part of its voting stock: of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation; or of substantially all the properties of another corporation, or (C) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (D) a recapitalization, or (E) a mere change in identity, form, or place of organization, however effected.

(2) The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case

of a reorganization resulting from the acquisition by one corporation of stock or properties of another.

Revenue Act of 1936, Section 115(a) (49 Stat. 1682).

(a) DEFINITION OF DIVIDEND.—The term "dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Second Revenue Act of 1940 (54 Stat. 1004).

SEC. 501. EARNINGS AND PROFITS OF CORPORATIONS.

(a) UNDER INTERNAL REVENUE CODE.—Section 115 of the Internal Revenue Code is amended by inserting at the end thereof the following new subsections:

"(l) EFFECT ON EARNINGS AND PROFITS OF GAIN OR LOSS AND OF RECEIPT OF TAX-FREE DISTRIBUTIONS.—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

"(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

"(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. Where in determining the adjusted basis used in computing such realized gain or loss the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings or profits, then the latter adjustment shall be used in determining the increase or decrease above provided. Where a corporation receives (after February 28, 1913) a distribution from a second corporation which (under the law applicable to the year in which the distribution was made) was not a taxable dividend to the shareholders of the second corporation, the amount of such distribution shall not increase the earnings and profits of the first corporation in the following cases:

"(1) No such increase shall be made in respect of the part of such distribution which (under such law) is directly applied in reduction of the basis of the stock in respect of which the distribution was made.

"(2) No such increase shall be made if (under such law) the distribution causes the basis of the stock in respect of which the distribution was made to be allocated between such stock and the property received.

"(m) Earnings and Profits—Increase in Value Accrued Before March 1, 1913. (This subsection omitted as not material.)"

(b) Effective Date of Amendment.—The amendment made by subsection (a) shall be applicable to taxable years beginning after December 31, 1938.

(c) Under Prior Acts.—For the purposes of the Revenue Act of 1938 or any prior Revenue Act the amendments made to the Internal Revenue Code by subsection (a) of this section shall be effective as if they were a part of each such Revenue Act on the date of its enactment. Nothing in this subsection shall affect the tax liability of any taxpayer for any year which, on September 20, 1940, was pending before, or was theretofore determined by, the Board of Tax Appeals, or any court of the United States.

REGULATIONS.

Regulations 94, Article 115-3.

Regulations 101, Article 115-3.

Regulations 103, Section 19.115-3.

Art. 115-3. **Earnings or profits.** In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive. Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22(a) of the Act or corresponding provisions of prior acts.* Gains and losses within the purview of section 112 or corresponding provisions of prior Acts* are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section. Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends.

In the case of a corporation in which depletion is a factor in the determination of income, the only depletion deductions to be considered in the computation of earnings or profits are those based on (1)

*Section 19.115-3 reads "prior Revenue Acts".

cost or other basis, if the depletable asset was acquired subsequent to February 28, 1913, or (2) adjusted cost or March 1, 1913, value, whichever is higher, if acquired prior to March 1, 1913. Thus, discovery and percentage depletion under all Revenue Acts for mines and oil and gas wells should not be taken into consideration in computing the earnings or profits of a corporation.

A loss sustained for a year prior to the taxable year does not affect the earnings or profits of the taxable year. However, in determining the earnings or profits accumulated since February 28, 1913, the excess of a loss sustained for a year subsequent to February 28, 1913, over the undistributed earnings or profits accumulated since February 28, 1913, and prior to the year for which the loss was sustained, reduces surplus as of March 1, 1913, to the extent of such excess. And, if the surplus as of March 1, 1913, was sufficient to absorb such excess, distributions to shareholders after the year of the loss are out of earnings or profits accumulated since the year of the loss to the extent of such earnings.

With respect to the effect on the earnings or profits accumulated since February 28, 1913, of distributions made on or after January 1, 1916, and prior to August 6, 1917, out of earnings or profits accumulated prior to March 1, 1913, which distributions were specifically declared to be out of earnings or profits accumulated prior to March 1, 1913, see section 31(b) of the Revenue Act of 1916, as amended by section 1211 of the Revenue Act of 1917.

Regulations 94, Article 115-11.

Art. 115-11. **Effect of earnings or profits on (of) certain tax-free exchanges and tax-free distributions.**—If, under the law applicable to the year in which any transfer or exchange of property after February 28, 1913, was made (including transfers in connection with a reorganization or a complete liquidation under section 112(b)(6) and intercompany transfers of property during a period of affiliation), gain or loss was not recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations.

The general rule provided in section 115(b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, to its shareholders of stock or securities in such corporation or in another corporation a party to the reorganization—

(A) in any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corporation (see section 112(g) of the Revenue Act of 1932); or

(B) in any taxable year (beginning before January 1, 1936, or on or after such date) in exchange for its stock or securities (see section 112(b)(3)

if no gain to the distributees from the receipt of such stock or securities was recognized by law.

(2) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the sixteenth amendment to the Constitution or because exempt to him under section 115(f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

A distribution described in paragraphs (1) and (2) above does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange.

For the purposes of this article, the terms "reorganization" and "party to the reorganization" shall, for any taxable year beginning before January 1, 1934, have the meanings assigned to such terms in section 112 of the Revenue Act of 1932, and for any taxable year beginning after December 31, 1933, and before January 1, 1936, have the meanings assigned to such terms in section 112 of the Revenue Act of 1934.

Regulations 101, Article 115-11.

Art. 115-11. **Effect on earnings or profits of certain tax-free exchanges and tax-free distributions.** If, under the law applicable to the year in which any transfer or exchange of property after February 28, 1913, was made (including transfers in connection with a reorganization or a complete liquidation under section 112(b)(6) and intercompany transfers of property during a period of affiliation), gain or loss was not recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations.

The general rule provided in section 115(b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, to its shareholders of stock or securities in such corporation or in another corporation a party to the reorganization—

(A) in any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corporation (see section 112(g) of the Revenue Act of 1932); or

(B) in any taxable year (beginning before January 1, 1938, or on or after such date) in exchange for its stock or securities (see section 112(b)(3))

if no gain to the distributees from the receipt of such stock or securities was recognized by law.

(2) The distribution in any taxable year (beginning before January 1, 1938, or on or after such date) of stock or securities, or other property or money, to a corporation in complete liquidation of another corporation, under the circumstances described in section 112(b)(6) of the Revenue Act of 1936 or section 112(b)(6) of the Revenue Act of 1938.

(3) The distribution in any taxable year (beginning after December 31, 1937) of stock or securities, or other property or money, in the case of an exchange or distribution described in section 371 (relating to exchanges and distributions in obedience to orders of the Securities and Exchange Commission), if no gain to the distributees from the receipt of such stock, securities, or other property or money was recognized by law.

(4) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the sixteenth amendment to the Constitution or because exempt to him under section 115(f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

A distribution described in paragraph (1), (2), (3), or (4) above does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange. In the case, however, of amounts distributed in liquidation (other than a tax-free liquidation or reorganization described in paragraph (1), (2), or (3) above) the earnings or profits of the corporation making the distribution are diminished by the portion of such distribution properly chargeable to earnings or profits accumulated after February 28, 1913, after first deducting from the amount of such distribution the portion thereof allocable to capital account.

For the purposes of this article, the terms "reorganization" and "party to the reorganization" shall, for any taxable year beginning before January 1, 1934, have the meanings assigned to such terms in section 112 of the Revenue Act of 1932; for any taxable year beginning after December 31, 1933, and before January 1, 1936, have the meanings assigned to such terms in section 112 of the Revenue Act of 1934; and for any taxable year beginning after December 31, 1935, and before January 1, 1938, have the meanings assigned to such terms in section 112 of the Revenue Act of 1936.